Testimony of

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To the Subcommittee on Capital Markets, Insurance and GSEs

Of the Committee on Financial Services

United States House of Representatives

Hearing on Legislative Solutions for the Rating Agency Duopoly

June 29, 2005

H.R. 2990: Creating a Competitive Rating Agency Sector

Good morning, Mr. Chairman, Ranking Member Kanjorski and members of the Subcommittee. Thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow of the American Enterprise Institute, and these are my personal views.

It is a pleasure to speak in support of H.R. 2990, a pro-competitive, pro-investor alternatives, pro-market discipline bill. In January, 2005, the AEI published an article of mine entitled, "End the Government-Sponsored Cartel in Credit Ratings": H.R. 2990 would do just that.

My article concluded with the following thoughts, to which I continue to subscribe:

"In the truly procompetitive and best case, not only would the term 'NRSRO" be dropped, but the regulatory requirement of designation of approved rating agencies itself would be eliminated. That requirement has produced unintended effects never imagined when it was introduced in 1975, and it is time for it to retire.

"In its place, the responsibility to choose among rating agencies and their services would belong to investors, financial firms, securities issuers, creditors, and other users of ratings—in short, to the market. Imagine that!

"Under these desirable circumstances, a competitive market test will determine which rating agencies turn out to be 'widely accepted by the predominant users of securities ratings,' and competition will provide its normal benefits of better prices, innovation, customer choice, and efficiency."

One practical problem this best case had to confront was that the SEC's "NRSRO" designation has over three decades become enshrined in a very large and complex web of interlocking regulations and statutes affecting all kinds of financial actors. The combined effect was to spread the unintended anti-competitive force of the SEC's regulation throughout the financial system, resulting in a rating agency sector marked by effective government sponsorship of the existing dominant firms, too few customer alternatives, too little price and service competition, and extremely high profits for the favored firms. How could we untangle this regulatory web, or (to change the metaphor) cut this Gordian knot of interacting rules?

H.R. 2990 cuts the Gordian knot in what I think is a brilliant and elegant fashion by keeping the abbreviation "NRSRO," but completely changing its meaning. By changing the first "R" from "Recognized" to "Registered," it moves from a restrictive designation regime, to a procompetitive disclosure regime. This change, it seems to me, is in the best tradition of the American financial market theory and practice: competition based on disclosure, with informed investors making their own choices, for use of credit ratings as well as other financial decisions.

Confirmation of the anti-competitive nature of the existing regulation comes from a recent investment recommendation to buy the stock of one of the rating agencies, which correctly states:

"Companies are not unlike medieval castles. The most successful are those that boast some sort of economic moat that makes it difficult, if not impossible, for competitors to attack or emulate. <u>Thanks to the fact that the credit ratings market is heavily regulated by the federal government, [this rating agency] enjoys a wide economic moat</u>." (emphasis added)

The government should not be in the business of creating such "economic moats" to protect certain rating agencies, and H.R. 2990 properly takes it out of this business.

An important advantage of the change H.R. 2990 would introduce is to allow multiple rating agency pricing models to compete for customer favor. While the dominant pricing model is now that securities issuers pay for credit ratings, it is arguable that having investors purchase the ratings creates a superior incentive structure. This was of course the original historical model. In my view, there should be no regulatory prescription of one model or the other: the market should use whichever credit rating providers best serve the various needs of those who use the ratings.

I believe the decentralization of decisions implied by a competitive disclosure-based regime is wholly positive. Investors and other market actors, as well as many regulators, will have to think about how credit ratings should be used and what related policies they will wish to adopt. They will be expected to make informed judgments, rather than merely following an SEC rule about who is designated as “recognized.” The SEC itself may wish to re-examine its regulation about how credit ratings must be used for calculating capital requirements.

Good legislation can create the environment for positive developments, but a fully competitive rating agency market will not happen all at once. There are significant natural barriers to entry in this sector, including the need to establish reputation, reliability and integrity; the prestige factor involved in the purchase of opinions and judgments; and the natural conservatism of institutional risk management policies.

Because the desirable transition to a more competitive rating agency sector would be evolutionary, I believe any concern about disruption of the fixed income markets is misplaced. This would be a change which, in my opinion, the bond and money markets would benefit from and take in stride.

No matter what the regime, we cannot hope for credit ratings ever to have uniform success in predicting future credit performance, or to create a world in which there are never ratings mistakes, any more than in any other endeavor which tries to deal with future risks and uncertainties. But this emphasizes the importance of a vibrant marketplace of analysis, ideas, forecasts, risk assessments, and credit ratings.

In summary, I believe H.R. 2990’s approach is in the best tradition of competition and disclosure, rather than regulatory prescription and government sponsorship. As always, greater competition will in time bring about better customer service, more innovation, more customer alternatives, greater price competition, reduced duopoly profits, and greater efficiency in the credit rating agency sector.

Thank you again for the chance to be here today.